FOR ARGUMENT

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IN THE

Supreme Court of the United States

October Term, 1979

No. 79-66

PETER E. AARON,

Petitioner,

vs.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR PETITIONERS

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The SEC in its brief contends that this court's decision in *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 does not extend to SEC injunction actions primarily for three reasons: (1) established equity practice prior to the enactment of the 1933 and 1934 Acts, (2) the precedents under the New York State Blue Sky Law—the Martin Act and (3) the Court's decision holding in *Capital Gains.* None of these arguments will withstand analysis.

A. The SEC in its brief—to support a differentiation between the required elements of an SEC injunction action, as distinguished from a civil damage claim under the anti-fraud provisions of the 1933 and 1934 Acts—points to established principles of equity "providing relief for de-

frauded plaintiffs without proof of scienter," citing, among other authorities, the House of Lords' decision in *Derry* v. *Peck,* 14 App. Case 337 (1889), which at 359 (the page cited by the SEC), states that

> "Where rescission is claimed, it is only necessary to prove that there was misrepresentation; then, however honestly it may have been made, however free from blame the person who made it, the contract, having been obtained by misrepresentation, cannot stand."*

The SEC slights over the fact that relief granted under such principles of equity was the rescission of a single individual transaction. Equitable relief in such circumstances was designed so as to prevent the seller from profiting from a misrepresentation, however innocent, regarding the property which he sold.

This principle of equity was designed to do justice between the parties to a single transaction. It is clearly different from the broad injunctive power asserted by the Commission under the 1933 and 1934 Acts against any violations of the generalized catch-all, antifraud provisions of Section 17 and Rule 10b-5. The only consequence of the rescission of a transaction is the loss of a particular deal in accordance with equitable principles only loosely described as "equitable fraud."** In contrast, an injunction in

* Similarly, *Smith* v. *Richards,* 38 U.S. 26 (1839), cited by the SEC Br. 25, states that for purposes of a rescission action "even if the party innocently misrepresents a fact by mistake, it is equally conclusive."

** Innocent or negligent misrepresentations giving rise to equitable claims for rescission are not commonly referred to as, and are distinguished from, fraud. For example, the New York Court of Appeals in *Bloomquist* v. *Farson,* 118 N.E. 855, 856 (1918), ruled that "an action may be maintained in equity to rescind a transaction

(footnote continued on following page)

SEC actions subjects defendant to the potent weapon of the court's contempt powers, to publicity potentially destructive of its business and to grave collateral consequences, including in the case of a broker-dealer, exclusion from the securities business.

In case of rescission, equity acts against a blameless person because between the seller and the buyer it is more equitable to relieve the buyer from the contract which he entered on the basis of an innocent misrepresentation. It does not try to assign or fix blame or fault. In contrast, an injunction under the 1933 and 1934 Acts is issued against a defendant because he is violating, or has the propensity to violate, the law. It judges the defendant culpable and tags him as being guilty of, and/or prone to, "fraud."

B. The SEC in its brief also places reliance on the judicial interpretation of the Martin Act (N.Y. Gen. Bus. Law §§ 352-353 consol. 1921) in *People* v. *Federated Radio Corporation,* 244 N.Y. 33, 154 N.E. 655 (1926). The Martin Act was a New York State statute which prohibited in general terms fraudulent conduct and misrepresentation in connection with the sale of securities. It made such conduct subject both to criminal penalties and injunctive relief. The Martin Act was limited to general antifraud provisions and it did not, as did the 1933 Act, establish a comprehensive

(footnote continued from preceding page)

which has been consummated through misrepresentation of material facts *not* amounting to fraud." Similar, the Restatement of Torts (1938) clearly distinguishes between "fraudulent misrepresentations" in § 525 *et seq.* and "negligent misrepresentations in § 552. The SEC quotation from *Smith* v. *Richards* (Br. 25) referring to "a false representation, whether knowingly or not" as a "fraud" is contrary to general legal usage and not necessary for the decision in that case. Moreover, it is inconsistent with the language of p. 38 of the same opinion stating "it is immaterial to the purchaser whether the misrepresentation proceeded from fraud or mistake. The injury to him is the same, whatever the motives of the seller."

scheme for the registration of securities and the imposition of liabilities.

Federated Radio involved false statements in a prospectus, and the court's decision there was grounded on the then established principle that "promoters are under a duty to make reasonable investigation before issuing a prospectus." The court ruled therefore that "to the extent that they fail in the performance of their duty, lack of scienter will not relieve them from liability in actions brought under the Martin Act." The court specifically reserved the decision on "whether a like duty attaches to persons not promoters." In *Federated Radio* the court expanded the Martin Act to cover an obvious and well established evil—misrepresentations in prospectuses—against which there were no specific prohibitions or remedies.

Congress, in enacting the Securities Act of 1933, specifically rejected proposals simply to adopt an antifraud statute similar to the Martin Act and instead, adopted a statute which dealt explicitly with the problem of negligent misrepresentations in prospectuses, imposing an absolute liability on issuers and a duty of reasonable investigation or care on directors and experts.

C. The SEC, to avoid the plain thrust and meaning of the *Hochfelder* decision, places its reliance instead on this Court's earlier decision in *SEC* v. *Capital Gains,* 375 U.S. 180 (1963). In that case, the Court upheld a preliminary injunction issued under the Investment Advisors Act" requiring a fiduciary to disclose to his client, not all his security holdings, but only his holdings in recommended securities just before and after the issuance of his recommendations."

The Court held that for purposes of issuing a preliminary injunction under this Act, "Congress did not intend to require proof of intent to injure or actual injury to the

client." The Court's opinion in that case is heavily premised upon the legislative history of Section 206, and the "delicate fiduciary nature of an investment advisory relationship." Here, however, the antifraud provisions of the 1933 and 1934 Acts, as broadly construed by the courts, regulate a myriad of commercial transactions which are not of a fiduciary nature. Section 10(b) of the 1934 Act is a " 'catch-all clause, to prevent manipulative devices' ", (*Hochfelder* at 202) and Section 17(a) deals generally with "Fraudulent Interstate Transactions." The law has always attached more stringent obligations on fiduciaries. In the absence of special fiduciary obligation, the threshold for using the tool of injunctive relief is appropriately set higher.

In addition, the SEC revels in Justice Goldberg's characterization in *Capital Gains* of an injunctive as a "mild prophylatic"—a term quoted from the Second Circuit's dissenting opinion in *Capital Gains.* However, as Judge Friendly recently stated in *SEC* v. *Commonwealth Chemical Securities,* 574 F.2d 90, 99 (2d Cir. 1978) "experience has shown that an injunction often is much more than a 'mild prophylatic.' In some cases, the collateral consequences of an injunction can be very grave." The experience referred to by Judge Friendly makes clearly outmoded any further reliance on the "mild prophylatic" nature of injunctive relief. Injunctive relief under the antifraud provision, recognized now as a weighty remedy, must be reserved for cases of intentional or reckless conduct. It was not intended and should not be construed as being a remedy against mere negligence.

D. The SEC, to bolster its tenuous legal arguments, makes a plea on policy grounds. It states that "if deception stemming from carelessness is not prohibited by these statutory provisions, the economic interests of participants in securities markets would be seriously impaired." As this

Court stated in *Hochfelder,* where the "language and history are dispositive," there is no occasion to examine the additional considerations of "policy." See also, *Touche Ross & Co.* v. *Redington,* 99 S.Ct. 2479 (June 8, 1979).

In any event, Congress did provide a considerable arsenal against careless misrepresentations. Among other things, it provided for stop-order proceedings to prevent the use of registration statements containing such misrepresentations and in the 1934 Act, Section 15(c)(4) provided for administrative orders requiring the correction of false reports filed with the Commission. Further, it imposed civil liabilities for innocent and/or negligent misrepresentations in registration statements.

If the remedies Congress has provided are not sufficient to deal with careless misrepresentations, the SEC should ask Congress for additional remedies especially structured to attack this problem rather than to ask this Court to construe the antifraud provisions to cover conduct not comprehended by the language or intent of these provisions.

E. The Second Circuit Court of Appeals found "it unnecessary to reach the question whether Aaron's conduct would support a finding of scienter (A13-A14)." Petitioner respectfully suggests that the Court did so because there was substantial evidence that his conduct was negligent and not intentional.

The trial record reveals that on just two separate occasions, several months apart, was petitioner made aware that misrepresentations were being made by other employees of E. L. Aaron & Co. In each instance, petitioner telephoned the branch office where those employees worked, informed them of the nature of the complaints, and requested that they discuss the matter with Lawn-A-Mat's attorney (182-183, 274-276, 426, 428, 519).*

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* Refers to the original trial transcript.

In light of this Court's decision in *Hochfelder,* the opinion of the Court of Appeals for the Second Circuit should be reversed and the cause remanded for further proceedings to decide whether petitioner's conduct would support a finding of scienter.

Respectfully submitted,

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